Volume 86 | Issue 4 Article 9

June 1984

Personal Residence: Disposition Alternatives

D. Frank Hill III
West Virginia University College of Law

STUDENT MATERIAL
Student Notes

THE PERSONAL RESIDENCE: DISPOSITION ALTERNATIVES

INTRODUCTION

This Note examines six alternatives available to a client who is planning the ultimate use or disposition of his personal residence.

As increasing numbers of homeowners reach retirement age, some no doubt will be suprised to find themselves in a position of moderate paper wealth, e.g., home equity, but quite disturbed to learn that they have but little real income on which to sustain themselves during their advancing years. Many persons in such a predicament do not comprehend the financial difficulties they and the ultimate beneficiaries of their estates will eventually face as a result of improvident planning.

This Note sets forth and discusses six courses of action for a homeowner in such a situation. Of necessity, the property and taxation implications will be emphasized, as will advantages and disadvantages of each alternative.

I. GIFT OF RESIDENCE TO CHILDREN

A. *Overview*

A homeowner may wish to make an outright gift of his[1] residence to the children. This presents a "clean" method of effecting the transfer, but underlying consequences, both tax and non-tax, may result if entered into blindly.

Initially, one must consider relevant factors such as the number of children, their ages, maritial status, health, occupation, station in life, financial position and mental capacity.

If the donors have more than one child and desire to accord each child a fair and equal share of their property, problems may well result in attempting to convey fractional interests in the same parcel of realty.

Caution should also be exercised when the parents are still capable of bearing children or are considering adopting children[2] subsequent to the date of transfer. This would thereby eliminate the children born or adopted after the conveyance from sharing in their parents' estate to the extent of the value of the previously

---

[1] Throughout this Note, in the interest of brevity and consistency, reference will be made to the masculine gender. It is intended to include both women and men.

[2] W. VA. CODE § 48-4-5 (1980) provides that for the purposes of descent and distribution, from and after the entry of an order of adoption, such child shall inherit from only the adopting parent. All former rights of inheritance from the child's natural parents, unless a natural parent is the spouse of the adopting parent, shall cease.

transferred residence unless specific provision is made for such child(ren) in the parents' will or through compensating inter vivos gifts.

A parent with more than one child should also be advised of the issue of "advancement" as it may relate to an alleged preference toward one or more child(ren). The advancement doctrine[3] is only applicable to the estate of a person dying wholly intestate or intestate as to any part of his estate. Therefore, a practitioner advising a lifetime gift of a residence should review the transferors' will, taking into consideration any dispositive alternatives occasioned as a result of the gift. The attorney should also be sure that the will possesses a sufficiently broad residuary clause to prevent any property from passing by intestacy.

For purposes of this Note, it will be presumed that the transferee/children have attained the age of majority, which in West Virginia is eighteen years.[4] However, should a transferor wish to convey realty to a person under the age of eighteen, the appointment of a guardian for the child is required.[5]

Concurrently with the determination of the transferee's age should be an objective evaluation of his health and mental condition and station in life, i.e., needs, occupation and financial condition.

The transferor must also be advised of the irrevocability of such an action; after the transfer, he no longer has any right of possession or enjoyment of his former residence. In fact, as will be developed later, such total relinquishment of right, title, use and possession is required for certain estate tax provisions.[6]

The practitioner also should inquire into the intended donee's marital status since, upon the vesting of title to real property, the donee's spouse will acquire an inchoate dower interest in the realty.[7]

Further inquiry is required to establish whether the donee/child has a valid will which provides for a devise of the gifted property back to the donor. Of course, if the donee did not take the residence in survivorship form with the spouse and if there are no children, the real estate will descend to the spouse in the absence of a will.[8] If this occurs, the residence is removed from ownership within the donor's

---

[3] W. VA. CODE § 42-4-1 (1982). An advancement is an irrevocable gift made by a parent or ancestor, during the lifetime of either, to one standing in the place of a prospective heir or distributee, with the intention on the part of the donor that such gift shall represent a part or whole of the share of his estate to which the donee would become entitled upon the death of the donor intestate. Whether a gift shall be treated as an advancement depends upon the intention of the donor. *See* Hedrick v. Harper, 135 W. Va. 47, 62 S.E.2d 265 (1950).

[4] W. VA. CODE § 2-2-10(aa).

[5] W. VA. CODE § 7-1-3 provides for the appointment of a guardian by the county commission.

[6] *See infra* text accompanying note 32.

[7] W. VA. CODE § 43-1-1 (1982). An inchoate dower interest is a spouse's interest in the lands of her spouse during his life, which may become a right of dower upon his death. The wife must join in a granting deed which operates as a release of the inchoate interest and not as a conveyance of the underlying realty.

[8] W. VA. CODE § 42-1-1(b) (1982).

family, thereby possibly frustrating the donor's intent. In the event the donee dies with issue surviving, the residence would then descend (in the absence of a will) to the children, subject to the spouse's dower interest.[9]

The donor should also be advised that the prospective donee would be able to freely alienate the property when the title becomes vested, perhaps in contravention of the donor's wishes. Additionally, if the child were to encounter financial difficulty, the residence may be subject to bankruptcy proceedings. If the donor is willing to proceed, the income, gift and estate tax implications to both parties should be explored.

B. *Income Taxation Considerations*

[For purposes of this Note it is assumed that the residence has been used throughout the period of ownership solely as a personal residence of the donor and that no portion thereof has been used in a trade or business or in the production of rental income.]

The prospective donee will not be subject to any taxable income as a result of receiving the residence. The Internal Revenue Code (hereinafter referred to as the Code) provides that "gross income does not include the value of property acquired by gift...."[10] At this point, it will be necessary to delve into the intended donee's expected use of the residence, inasmuch as the manner of use may indeed have a significant impact on the decision of whether to make a transfer during one's lifetime or whether to allow the residence to remain vested in the donor.

If the intended donee is considering a subsequent sale of the residence, in most cases it would be to his advantage to request the owner to retain ownership. The benefit of this tax planning device lies in the fact that when property is acquired from a decedent (whether by bequest, devise or inheritance) its "basis" or cost in the hands of the transferee becomes its fair market value as of the date of death of the decedent.[11] This very advantageous result is generally referred to as the "step-up in basis" provision. This step-up (or possibly step-down) in basis provision is allowable only to the extent the property was included in the decedent's gross estate for federal estate tax purposes.[12]

For example, if the current owner's original purchase price was $20,000 in 1950 and since that time he has made documented capital improvements in the aggregate amount of $15,000, the property's basis would be $35,000.[13] Assume further that the donor is at an advanced age, has no spouse, title is held only in his name and the property's fair market value at the time he is considering a lifetime

---

[9] W. VA. CODE § 42-1-1 (1982).

[10] I.R.C. § 102(a) (1982) [The Internal Revenue Code of 1954, as amended and codified at 26 U.S.C. §§ 1-9602 (1982), is hereinafter referred to in the text as "the Code."].

[11] I.R.C. § 1014(b)(1) (1982).

[12] I.R.C. §§ 2033, 2040(b)(1)-(2) (1982).

[13] I.R.C. §§ 1012, 1016(a)(1) (1982).

transfer is $150,000. If the donee intends to sell the property shortly after its transfer, the donee would be subject to a capital gain in the amount of $115,000 because the donee's basis ($35,000) is carried over from the donor.[14]

The donor would be considered to have made a taxable gift of $140,000 (a fair market value of $150,000 for the property[15] less the annual exclusion of $10,000).[16] Assuming the donor had not made any prior taxable gifts, no federal gift tax would be due because the Unified Credit Against Gift Tax[17] effectively shelters the taxable gift ($140,000) from the payment of gift tax so long as the cumulative value of such taxable gifts made after June 6, 1932 has not exceeded the amount of the exemption equivalent available for the year in which the taxable gift occurred, which amount for 1984 is $325,000.

When the donee sells the recently gifted property he will be required to report $46,000 of ordinary income in his return for the year in which the sale was effected. This amount is calculated as follows:

Gross sales price (assumed at FMV)	$150,000
Less basis (carryover from donor)	35,000
Gain realized	$115,000
Less capital gain exclusion[18] of 60%	69,000
Gain to be recognized	$ 46,000

Upon qualification some additional tax relief may be gained through the use of income averaging.[19] Caution, though, should be exercised concerning the Alternative Minimum Tax[20] to which the capital gains excluded (here $69,000) are subject. Of recent note, West Virginia enacted its own Minimum Tax for periods beginning after April 1, 1983, which, with modifications, correlates with the federally imposed Minimum Tax.[21]

Assuming the donee's tax bracket is at the maximum rate of fifty percent,[22] the $46,000 of ordinary income resulting from the sale will result in an additional

[14] I.R.C. § 1015(a) (1982).

[15] I.R.C. § 2512(a) (1982).

[16] I.R.C. § 2503(b) (1982). By this section, a gift or gifts to any one person during the calendar year totalling or aggregating an amount or value of $10,000 or less is not to be considered in determining the total amount of taxable gifts of that or any subsequent calendar year. *See* H.R. REP. No. 201, 97th Cong., 1st Sess. 193-94 (1981).

[17] I.R.C. § 2505(a)-(b) (1982). The use of the unified credit against the tenative gift tax is mandatory. Rev. Rul. 79-398, 1979-2 C.B. 338.

[18] I.R.C. § 1202(a) (1982).

[19] I.R.C. §§ 1301-05 (1982).

[20] I.R.C. §§ 55, 57(a)(9)(A) (1982). This is a separately computed tax which is imposed on a taxpayer's "alternative minimum taxable income" as defined in section 55(b). It is intended to tax special types of income and certain deductions which are otherwise favored; these items are referred to as Tax Preferences.

[21] W. VA. CODE § 11-21-3(a)(3) (1983).

[22] I.R.C. § 1-5 (1982).

primary federal income tax of $23,000. This amount does not include any Minimum Tax that may be due as a result of this transaction.

As discussed later, the donee may be able to structure his sale in such a manner as to avail himself of the "Installment Method" of reporting.[23] This option has the effect of spreading the recognizable gain over the period in which payments are made; it may also completely eliminate the untaxed portion of the capital gain from being subject to the Alternative Minimum Tax. If the donor retains the property so as to result in inclusion in his gross estate, the property would receive a higher basis which would then be carried over to his devisee(s) or heir(s) and thus used in computing their profit (or loss) upon any eventual sale. The typical and most tax advantageous situation would be that, immediately upon receiving the property, the donee would sell it (presumably) at its fair market value, which would also be its newly acquired basis by having been included in the decedent's gross estate. Thus the sales price (amount realized) would equal the property's basis with no resulting gain.

Therefore, through proper planning the alert practitioner would be able to save the donee $23,000 of federal income taxes in addition to the resulting state income taxes.

C. *Gift and Estate Taxation Considerations*

If the owner nonetheless wishes to proceed with a gift to his child, the resulting gift tax must be computed.

Initially, one must determine the property's fair market value on the date of the gift.[24] A qualified independent real estate appraiser should be requested to prepare a written appraisal of the property to properly document its value. An allocation of the value between land and each building should also be made for depreciation purposes, if any.[25]

After the value is determined, it should be decided whether the donor's spouse wishes to join in making the gift. A gift made by either spouse to a third party is treated as having been made one half by each, provided their mutual consent is given with respect to all such gifts made by either of them during the calendar year in which they were married to each other. There is generally no apparent reason for the spouse not to join in making such a gift. The spouse must sign the return (Form 709 or 709-A) as a "Consenting Spouse;"[26] this in effect provides for the gift to be "split" between the parties and enables the donors to jointly claim a $20,000 annual exclusion[27] per donee as opposed to only a $10,000 annual exclusion if the donor alone makes the gift.

A further planning opportunity is available if the intended donee is married.

---

[23] I.R.C. § 453. *See infra* text accompanying note 72.

[24] I.R.C. § 2512(a) (1982).

[25] Treas. Reg. § 1.167(a)-5, T.D. 6500, 25 Fed. Reg. 11,402 (1960).

[26] I.R.C. § 2513(a)(2)-(b)(2) (1982).

[27] I.R.C. § 2503(b) (1982).

In such a case, the donors could transfer their home (in the form of joint tenancy or as tenants in common) to the donees, and thereby receive a $40,000 exclusion (assuming the donor's spouse joins as a consenting spouse).

The annual exclusion inures to the benefit of the donor to the extent of the number of donees to whom property is gifted.[28] For example, if parents wish to transfer cash to their son who is married and has two children, the parents may transfer, regardless of which parent owns the cash, free of gift tax (and not be required to use any of their lifetime Unified Credit Against Gift Tax) the aggregate sum of $80,000 per year as follows:

Father to:	Amount	Annual Exclusion	Taxable Gift
Son	$10,000	$10,000	$ -0-
Daughter-in-law	10,000	10,000	-0-
Grandchild-1	10,000	10,000	-0-
Grandchild-2	10,000	10,000	-0-
Mother to:			
Son	10,000	10,000	-0-
Daughter-in-law	10,000	10,000	-0-
Grandchild-1	10,000	10,000	-0-
Grandchild-2	10,000	10,000	-0-
Totals	$80,000	$80,000	$ -0-

To qualify for the annual exclusion, it is imperative that a "present interest" be transferred. This requires that the donee be immediately vested in the use, possession and enjoyment of the gifted premises.[29] If parents transfer a residence to their child and thereafter continue to live in the residence, the Internal Revenue Service generally takes the position that there was an understanding to that effect and includes the value of the residence in the parents' gross estate upon death. Revenue Rulings indicate that it seems to make no difference whether the parents occupied the residence exclusively[30] or together with their children (the tranferees).[31]

The Fourth Circuit, in *Guynn v. United States*[32] has supported the IRS's position, at least where the parent/donor has *exclusively* occupied the gifted residence. In *Guynn* the donor/parent continued to pay real estate taxes and repairs and did not pay any rent to the donee/daughter. A deed was executed and recorded and a gift tax return was filed. The court held that the "continued exclusive possession by the donor and the withholding of possession from the donee are highly significant factors."[33] Of importance, the court distinguished cases wherein there

[28] *Id.*
[29] *Id.* Treas. Reg. § 25.2503-3, T.D. 7238, 37 Fed. Reg. 28,727 (1972).
[30] Rev. Rul. 70-155, 1970-1 C.B. 189.
[31] Rev. Rul. 78-409, 1978-2 C.B. 234.
[32] 437 F.2d 1148 (4th Cir.), *rev'g*, 309 F. Supp. 233 (W.D. Va. 1971).
[33] *Id.* at 1150.

was joint occupancy by the donor and donee, holding that such a relationship would not necessarily require the inclusion of the property in the donor's gross estate.[34]

To effectively prevent the property's fair market value from being included in the donor's gross estate, the donor should not retain exclusive possession of the premises beyond the date of gift, a deed should be recorded, a gift tax return should be filed, and the donee should pay all taxes and expenses related to the property. Further, the parties should be counseled against entering into a formal understanding of granting or reserving in the donor a legal life estate. If the above suggestions are followed, the Internal Revenue Service would be hard pressed to prevail in an action to compel inclusion of the gifted property in the donor's gross estate.

D. *Transfers Within Three Years of Death*

1. Federal

In the event a person dies after December 31, 1981, a gift which was made within three years of a decedent's death will, in only limited situations, be required to be included in the decedent's gross estate.[35] Assuming the donor has not retained a life estate[36] in the residence and full compliance has been made with respect to the various gift tax reporting requirements,[37] the value of the property transfered will not be brought back into his gross estate.[38]

2. West Virginia

For purposes of the West Virginia Inheritance and Transfer Tax, there is a presumption that any gift or sale for less than full or adequate consideration made within three years prior to the death of the grantor or vendor was made in contemplation of death. Consequently, if the donor fails to survive for a period of three years beyond the effective date of the transfer, the full fair market value of the property will be subject to inheritance tax.[39]

Even if the donor reserves a life estate through language in the granting deed, the full fair market value of the property nevertheless will be subject to the inheritance tax upon his death because the transfer was intended to take effect in possession or enjoyment at or after the death of the donor.[40] This consequence highlights the necessity of making absolutely certain that an interest has not been retained in the gifted property; if such an interest has been retained, imposition

[34] *Id.*; Union Planters Nat'l Bank v. United States, 361 F.2d 662 (6th Cir. 1966); Estate of Binkley v. United States, 358 F.2d 639 (3d Cir. 1966); Estate of Linderme, 52 T.C. 305 (1969); and Estate of Gutches, 46 T.C. 554 (1966), *acq.* 1967-1 C.B. 2. *See* Sylvia H. Roemer, T.C. Memo 1983-509 (holding noninclusion of the residence when transferred from parents to child).

[35] I.R.C. § 2035(d) (1982).

[36] I.R.C. § 2036(a)(1)-(2) (1982).

[37] I.R.C. § 6019 (1982).

[38] I.R.C. § 2035 (1982).

[39] W. VA. CODE § 11-11-1(c) (1983).

[40] Kanawha Banking & Trust Co. v. Alderson, 129 W. Va. 510, 40 S.E.2d 881 (1946).

of West Virginia's Inheritance Tax may result.[41] West Virginia does not currently impose a gift tax on *inter vivos* tranfers, and, consequently, a properly structured transaction can mean substantial savings of inheritance taxes.

E. *Summary*

In sum, primary consideration must be given toward the ultimate use— retention or disposition—the intended donee desires to make of the property. Analysis of the donor's financial position, which becomes important when one considers the expected amount of his ultimate federal taxable estate, must also be examined. Depending upon the analysis of both the donor's and donee's goals and financial positions, significant federal income and estate taxes may be saved through the prudent and calculated use of a lifetime gift of one's residence.

II. Sale of Residence To Children

A. *Overview*

Because of the parents' financial position, they may need to receive some form of income from their residence. The alternative of a sale presents a fertile field for the practitioner to bring to bear several alternatives; all can significantly lessen income, estate and inheritance taxes, while at the same time provide the parents with a stream of income as well as insure the children's ownership of the home.

B. *Income Tax Consequences to Parents*[42]

Initially, the parent's "basis" or cost of the home must be determined.[43] This figure is then added to the aggregate sum of the costs (excluding one's own labor) of all improvements made to the home, e.g., permanent carpeting, structural additions and remodeling. The result is known as the property's "adjusted basis"[44] and is used to compute gain on its sale or exchange.

If the property was ever rented or converted to business use, a downward adjustment in its adjusted basis is required.[45] In the event of a sale of a personal residence, the practitioner should determine the taxpayers' ages. If certain criteria are met, a taxpayer may elect to exclude gain from the sale of a personal residence in an amount not to exceed $125,000.[46] Once the taxpayer has made an election under this provision with respect to a sale or exchange, he is foreclosed from making a similar election for any subsequent sale or exchange of a principal residence.[47] To the average homemaker, this exclusion is truly phenomenal in scope and size.

---

[41] W. Va. Code §§ 11-11-2 to -3 (1983).

[42] The alternative of a part gift-part sale is beyond the scope of this Note.

[43] I.R.C. § 1012 (1982). The property's original cost or basis will be either its original purchase price or its total construction cost.

[44] I.R.C. §§ 1011(a), 1016(a)(1) (1982).

[45] I.R.C. § 1016(a)(2) (1982).

[46] I.R.C. § 121(b)(2) (1982).

[47] *Id.*

Listed briefly are the substantive requirements that must first be met to qualify for this provision. (It should be noted that whether the vendee is a child or a third party is irrelevant so long as the sales price and any other related terms and conditions are *bond fide.*) Prerequisites are that:

1. The exclusion must be elected.[48]

2. The taxpayer must have attained the age of 55 before the date of sale.[49] It is suggested that the practitioner also inquire into marital status, prior marriages, previous elections and the manner in which the property is currently held (whether in joint tenancy or as tenants in common). These questions should provide a basis to determine if further detailed research will be required in order to comply with a series of special rules.[50]

3. The taxpayer must have owned and used the property as his principal residence for periods aggregating three years or more during the five-year period ending on the date of the sale.[51]

Because this elective exclusion is available only once during a taxpayer's lifetime, it must be borne in mind that in some situations, especially if the resulting recognizable gain is small, it may be extremely advantageous to forego the use of this elective exclusionary provision and instead recognize the gain (generally capital in character) and pay the resulting tax. Moreover, this exclusion is available to West Virginia taxpayers to the extent allowable under federal law.[52]

Assuming compliance with the above threshold requirements, the maximum amount of *gain* subject to exclusion is $125,000 ($62,500 in the case of a separate return by a married individual).[53]

Presented below is an example of the normal calculation:

Sales price		$180,000
Less costs of the sale		– 6,000
Adjusted sales price (amount realized)		$174,000
Less adjusted basis		
Original purchase price	$ 45,000	
Improvements (capital in nature)	+ 20,000	– 65,000
Gain realized		$109,000
Less exclusion under section 121(b)(1)		109,000
Gain recognized		$ NONE

[48] I.R.C. § 121(a)-(c) (1982); Treas. Reg. § 1.121-4(b), T.D. 7614, Fed. Reg. 24,840 (1979).
[49] I.R.C. § 121(a)(1) (1982).
[50] I.R.C. § 121(d)(1)-(2) (1982).
[51] I.R.C. § 121(a)(2) (1982); Treas. Reg. § 1.121-1(c)-(d), T.D. 7614, Fed. Reg. 24,840 (1979).
[52] W. VA. CODE § 11-21-1 (1983).
[53] I.R.C. § 121(b)(1) (1982).

In this example the taxpayer "wasted" part of his lifetime exclusion in the amount of $16,000 ($125,000 maximum amount, less gain *realized* but not *recognized* of $109,000). However, had the adjusted basis been lower by more than $16,000 or the adjusted sales price been higher by more than $16,000, the difference would have exceeded the maximum exclusion amount of $125,000; capital gains taxation would then apply. On balance, it seems that the election in this case should be made; otherwise, the full $109,000 would be subject to immediate taxation unless the residence would have been replaced in accordance with the rollover of gain provisions.[54]

As can be seen from this example, the taxpayers have exchanged a non-income earning asset worth $180,000 for cash (assuming there was no debt against the property which would have had to have been paid) in the amount of $174,000, the adjusted sales price.[55] If the taxpayers invest this sum in a manner that would yield a return of ten percent before income taxes, they would be able to receive approximately $1,500 per month while still preserving their principal of $174,000. In the event they require more than $1,500 per month, an investment program could be established which would pay them a fixed sum per month over their joint life expectancy, so that at the expiration of such pre-established period of time X thousands of dollars would remain invested. During this time all interest earned would have been paid to them while a portion of the principal would have been distributed. The interest portion, of course, would be subject to taxation[56] although any amount received from the principal portion would not be.

Through the proper portfolio of taxable and tax-exempt deposits or investments it is possible to shelter the entire earnings of the fund ($174,000) from federal income taxation. Hence, through proper utilization of this exclusion,[57] the taxpayer can be postured to enjoy an increased standard of living and avoid all liability to the federal fisc.

---

[54] I.R.C. § 1034 (1982). This planning device is not appropriate for the purposes of this Note. However, attention is directed to Code section 1034(a) which provides that if an old residence is sold, and within a two-year period before or after such sale date, a new principal residence is purchased and used by the taxpayer as his principal residence, any gain from such sale *shall be recognized* only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence. Here, the practitioner should be alert to advise the taxpayer that if he desires to avail himself of the lifetime exclusion pursuant to Code section 121, the old residence cannot be replaced within the two-year period with a new or replacement residence. If it is, the rollover provisions will take precedence over the lifetime exclusion provision, which may still be applied but will alter the basis of the replacement residence. The basis is partially determined by the amount of the nonrecognized gain, and not by the amount of the recognized gain. *See* I.R.C. § 1016(a)(7) (1982).

From a planning perspective, since a taxpayer can elect the lifetime exclusion any time within three years after a return is due for the year of sale, he can wait and see whether he will replace the residence and qualify for tax deferral under the rollover provisions of Code section 1034 before electing the lifetime exclusion under Code section 121.

[55] I.R.C. § 1034(b)(1) (1982); Treas. Reg. § 1.1034-1(b)(3), (6), T.D. 7625, 44 Fed. Reg. 31,013 (1979).

[56] I.R.C. § 61(a)(4) (1982).

[57] I.R.C. § 121 (1982).

For West Virginia residents over the age of 65, an amount of income not to exceed $8,000 per year is excluded from personal income taxation.[58] Because the exclusion of up to $8,000 per year is available to each taxpayer to the extent of his federal adjusted gross income (as defined in IRC Section 62), in the situation of a husband and wife it would seem imperative that their asset holdings be structured so as to take full advantage of each spouse's potential exclusion of $8,000. If the assets are held jointly, no problem would be present. But if the wife held investments and deposit accounts solely in her name and the total earnings were $17,000, on the joint West Virginia tax return it would seem a deduction of only $8,000 would be allowed since her husband in effect had no federal adjusted gross income as the statute requires. In this case, by merely altering the assets' form of ownership to joint ownership or sole ownership in the name of the husband, an additional $8,000 could be put beyond taxation for West Virginia purposes, thus leaving only $1,000 subject to taxation.

Hence, in our example, (assuming no other income) the couple would not owe any income taxes to the state of West Virginia. Additionally, effective for tax years beginning after January 1, 1984, the West Virginia personal exemption is $800 per person per year;[59] the combined exemption is $1,600 per year per couple. Merging the exclusion and the exemption, a married couple, both of whom are age 65 or older, may now have taxable income of $17,600 per year and not be subject to West Virginia taxation.

Attention is directed to the recently enacted Code section 128, which provides that, subject to certain requirements, a taxpayer may exclude from taxable income for taxable years beginning after December 31, 1984, qualifying interest income in an amount not to exceed fifteen percent of the lesser of:

(1) $3,000 ($6,000 in the case of a joint return), or

(2) the taxpayer's adjusted taxable interest income.[60]

Accordingly, in our example a married couple filing a joint return with qualifying interest income greater than $6,000 would be entitled to exclude from their federal gross income the aggregate sum of $900 ($6,000 x fifteen percent). This federal exclusion has not yet been overridden by the West Virginia Legislature, but if it is, it would result in an "add back" as a modification to increase West Virginia taxable income.

Through the proper structuring of the couple's investment program and full use of the applicable federal[61] and state[62] personal exemptions, the practitioner may assist an elderly couple in significantly reducing their income tax liability to both the federal and state authorities.

---

[58] W. VA. CODE § 11-21-12(c)(7) (1983).
[59] W. VA. CODE § 11-21-16(a) (1983).
[60] I.R.C. § 128(b)(1)-(2) (1982).
[61] I.R.C. § 151 (1982).
[62] W. VA. CODE § 11-21-16(a)-(b) (1983).

C. *Estate and Inheritance Tax Considerations*

One of the prime tax benefits of entering into a sale of one's principal residence is that the taxpayer in effect "freezes" or "locks in" the value of the asset received in exchange for the residence, cash in the case of a complete sale or notes in the case of an installment sale.

Consequently, the taxpayers' gross estate is not subject to future inflation caused by market value increases in the underlying asset because the residence has been replaced with assets of relatively fixed value, cash and notes receivable. Reduction of the gross estate, though, may be made to the extent that the taxpayers consume or gift any part of the principal; in contrast, the gross estate may be augmented to the extent that the earnings of the investment program are greater than the taxpayers' consumption or gifts.

However, the average taxpayer whose primary asset is a home most likely will not possess sufficient assets which would exceed the amount to which the federal estate tax is applicable.[63] For 1984, a taxpayer may have a taxable estate of $325,000 and not be subject to federal estate tax. By 1987 (if not repealed or altered) a taxpayer's taxable estate may equal $600,000 and not be subject to the federal estate tax.

Further, if the real estate is held as a "qualified joint interest"[64] only one-half of the value of such property will be includable in the gross estate of the first spouse to die.[65] This same provision applies not only to real estate but to all types of property which are held or titled jointly between only the decedent and his spouse. Of great importance in this area is the new unlimited marital deduction which is allowable, for estates of decedents dying after 1981, to the extent property which is included in the decedent's gross estate passes or has passed to the surviving spouse.[66]

In the event an installment sale is elected, consideration should be given concerning the payee(s) of the notes or other evidence of indebtedness. Effective for tax years beginning after December 31, 1981, there is no gift tax consequence when property is transferred between spouses, e.g., a deduction in computing taxable gifts is allowed for the full value of the property passing to the donor's spouse.[67] For example, if a husband who currently holds title to real property solely in his name effects an installment sale in which his spouse joins in the deed conveying the property and takes back notes and a purchase money mortgage, he may be wise, from a estate tax perspective, to name as the payees both himself and his wife as joint tenants. The same ownership form may be made if the proceeds are invested in stocks, bonds or certificates of deposit. The donor/taxpayer has in effect

---

[63] I.R.C. § 2010(b) (1982).
[64] I.R.C. § 2040(b)(2) (1982).
[65] I.R.C. § 2040(b)(1) (1982).
[66] I.R.C. § 2056(a) (1982).
[67] I.R.C. § 2523(a) (1982).

made a non-taxable gift to his spouse of one-half of the property received in conjunction with the sale.

Potential savings of West Virginia Inheritance Tax is afforded jointly held property. If property is held jointly with survivorship, upon the death of the first joint tenant only fifty percent of the market value of the property, after deduction for any encumbrances, is subject to inheritance tax.[68] Even if the transfer between spouses is accomplished within the "three-years-in-contemplation-of-death" rule, still only fifty percent of the value of such property is subject to inheritance tax upon the first joint tenant's death.[69] If the property is not sooner disposed or gifted, then upon the survivor's death the full value of the same property is again subject to inheritance tax. Examination should also be made of the several dollar amount and transferee exemptions from imposition of this tax.[70] The transfer to joint tenancy means, in effect, that the eventual tax will be imposed one and one-half times rather than twice. This fifty percent exclusion is one of the few ways the oppressiveness of the West Virginia Inheritance Tax scheme may be lessened.

D. *Gift Tax Considerations*

For purposes of the above example, it is presumed the sale was *bona fide* and at arm's length as to sale price and terms. This being so, regardless of who the vendee might be, there would be no contestable element of a gift because the sale was made for "adequate and full consideration in money or money's worth."[71] Hence, the practitioner need not concern himself with the gift tax in such a sales alternative.

E. *Installment Sale Considerations*

Inasmuch as the lifetime exclusion[72] is available to a taxpayer only once,[73] one may still mitigate the taxation burden by structuring the transaction in such a manner so as to qualify for installment sale reporting. In fact, where the realized gain exceeds the maximum allowable exclusion of $125,000,[74] it may also be possible to elect installment reporting and thereby effectively defer recognition of the remaining gain to the future periods in which principal payments are received.

An installment sale is defined as "a disposition of property where at least [one] payment is to be received after the close of the taxable year in which the

---

[68] W. VA. CODE § 11-11-1(d) (1983); Newton v. Dailey, 280 S.E.2d 91 (W. Va. 1981).

[69] W. VA. CODE § 11-11-1(d) (1983); Estate of Resseger v. Battle, 152 W. Va. 216, 161 S.E.2d 257 (1968).

[70] W. VA. CODE § 11-11-4 (1983).

[71] I.R.C. § 2512(b) (1982).

[72] I.R.C. § 121 (1982).

[73] I.R.C. § 121(b)(2) (1982). But see I.R.C. § 121(b)(3) (1982) for an exception if the taxpayer made an election with respect to a sale or exchange on or before July 26, 1978.

[74] I.R.C. § 121(b)(1) (1982).

disposition occurs."[75] Any sale or dispostion meeting this definition *must* be reported under the installment method unless the taxpayer affirmatively elects out.[76]

The primary advantage to this accounting convention is that it affords taxpayers the opportunity to recognize gain for tax purposes in the year in which payments from the transaction are received—a matching of cash receipts with the resulting tax liability. Through this method, the "bunching" of otherwise recognizable income in a year in which no cash is received is eliminated.[77]

In the event the vendor desires to sell his personal residence, electing the installment method requires extreme care to assure compliance with the special rules applicable to certain deferred payments.[78] The likelihood of an applicable statutory exception[79] to these rules is quite remote, but nevertheless prudence would dictate examination.

The problem here is one of imputed interest. The seller of a capital asset who intends to finance the purchase for the buyer would prefer, of course, to construct the transaction so as to generate a greater portion of capital gain and to likewise reduce the portion of interest that he will earn on the indebtedness. In furtherance of this goal, taxpayers have attempted to artificially inflate the property's selling price and correspondingly reduce the rate of interest that the financing instrument provides to a rate below that of the prevailing market rate for like obligations. The Code effectively counters such contrivances.

For payments resulting from a sale or exchange of property entered into on or after July 1, 1981, a "test rate" of interest of nine percent per annum is required.[80] If this minimum interest rate is not met, the Internal Revenue Service will impute interest at the rate of ten percent per annum compounded semi-annually.[81] This imputation of interest will effectively increase the ordinary income portion (interest) and decrease the capital gain portion (principal) of each payment as it is received. The conservative approach would therefore dictate providing for a minimum of a nine percent interest rate to prevent a challenge by the Service which would ultimately result in a shift from capital gain to ordinary income treatment of a greater portion of each payment as received.

1. Lifetime Exclusion in Conjunction with an Installment Sale

For the purposes of the following example it is assumed that the taxpayer received cash or its equivalent in the amount of $75,000 within the year of sale

[75] I.R.C. § 453(b)(1) (1982).

[76] I.R.C. § 453(d) (1982).

[77] A taxpayer may benefit taxwise by fully recognizing an otherwise qualified installment sale when he is about to forfeit a net operating loss carryover as provided in I.R.C. § 172(b)(1)(B) (1982). This would obtain by netting the recognizable gain against the NOL and in effect save the NOL.

[78] I.R.C. § 483(c)(1)(A) (1982).

[79] I.R.C. § 483(f) (1982).

[80] Treas. Reg. § 1.483-1(d)(1)(ii)(C), T.D. 7781, 46 Fed. Reg. 34,569 (1981).

[81] Treas. Reg. § 1.483-1(c)(2)(ii)(C), T.D. 7781, 46 Fed. Reg. 34,569 (1981).

and financed the balance of $175,000 at an interest rate of nine percent per annum payable in ten equal annual installments of $27,268.52 (which includes principal and interest) with each installment due on the anniversary date of the sale.

The computation would be as follows:

1. Selling price, taken in the form of:		
Cash	$ 75,000	
Note(s) receivable (deferred payments)	175,000	$250,000
Less:		
Basis of residence	$ 40,000	
Selling expenses	10,000	50,000
2. Total gross profit		$200,000
3. Less lifetime exclusion		125,000
4. Gain to be realized		$ 75,000
5. Gross profit ratio ($75,000/250,000)		30%
6. Payments received in year of sale (cash)		$ 75,000
7. Gain recognized in year of sale ($75,000 x .30)		$ 22,500

2. Income Tax Considerations

This example shows the interplay between the installment sale provisions and the application of the lifetime exclusion. The lifetime exclusion is not given full effect in the year of sale, but is allocated over the period of time that these installment payments are received.[82] Assuming no additional payments are made to the taxpayer in the year of the sale (other than the cash downpayment of $75,000), the taxpayer must recognize and report a long-term capital gain of $22,500 which is subject to the sixty percent capital gain deduction. The taxpayer is required to report the sale of the home by attaching Form 2119 to his return for the year in which the sale occurred.[83] Each year subsequent to the year of sale, upon receipt of the annual payment from the purchaser/debtor, the taxpayer must allocate the portion of each payment attributable to interest, return of capital (basis) and capital gain.

[82] Rev. Rul. 80-249, 1980-2 C.B. 166.
[83] Treas. Reg. § 1.121-4(b), T.D. 7614, 44 Fed. Reg. 24,840 (1979).

Presented below is a schedule showing this allocation.

Year (after sale)	Total amount received	Interest	Principal	Remaining balance
1	$ 27,268.52	$15,750.00	$ 11,518.52	$163,481.48
2	27,268.52	14,713.33	12,555.19	150,926.29
3	27,268.52	13,583.37	13,685.15	137,241.14
4	27,268.52	12,351.70	14,916.82	122,324.32
5	27,268.52	11,009.19	16,259.33	106,064.99
6	27,268.52	9,545.85	17,722.67	88,342.32
7	27,268.52	7,950.81	19,317.71	69,024.61
8	27,268.52	6,212.21	21,056.31	47,968.30
9	27,268.52	4,317.15	22,951.37	25,016.93
10	27,268.45	2,251.52	25,016.93	-0-
Totals	$272,685.13	$97,685.13	$175,000.00	-0-

For illustration purposes, in year two the taxpayer must report interest income[84] in the amount of $14,713.33. In addition, long-term capital gain in includable to the extent of principal payments received ($12,555.19) times the Gross Profit Ratio (thirty percent), which results in $3,766.56, which is then subject to the sixty percent capital gain deduction[85] of $2,259.93. Thus, $1,506.63 is ultimately includable in ordinary income. Over the term of the ten year note, the aggregate annual taxable amount will be continually decreasing as a result of (1) the reduction of the annual interest portion, and (2) greater amounts of principal being received which are subject to the thirty percent Gross Profit Ratio and further subject to the sixty percent long-term capital gain deduction.

3. Gift and Income Tax Considerations

Gift tax liability may result from an eventual transfer of either a portion of the cash received or of the note(s) receivable.

If purely cash is gifted, it will qualify for the $10,000 annual exclusion per donee[86] and perhaps for increased benefits under spousal gift-splitting.[87] Complexities arise regarding the gifting of the note itself. As long as the seller of the property retains ownership of the installment obligation, he reports the income and gain attributable to the instrument in the year in which payments are made thereon, all of which is in accordance with the underlying concept of the installment or

[84] I.R.C. § 61(a)(4) (1982).
[85] I.R.C. § 1202(a) (1982).
[86] I.R.C. § 2503(b) (1982).
[87] I.R.C. § 2513 (1982).

cash method of accounting. However, once the owner disposes of the obligation, the heretofore unreported gain (or loss) is recognizable in the year of such disposition.[88]

Therefore, if the owner is considering gifting the note, both income tax and gift tax problems arise. For gift tax purposes, a taxable gift will result to the extent of the fair market value of the note at the date of the gift.[89] Valuation of a term note with a fixed rate of interest may require substantial discounting in order to yield a return comparable to prevailing investment instruments.

For income tax purposes, the Code requires recognition of the gain (or loss) in the year of disposition.[90] The gain (or loss) is calculated as the difference between the basis of the obligation[91] and the amount realized (in the case of a sale or exchange)[92] or its fair market value (in the case of a disposition by means other than a sale or exchange).[93] In the example above, if the taxpayer gifted the note immediately after receiving the annual payment of principal and interest in year four, the then remaining balance would be $122,324.32, but, because the interest rate is fixed at nine percent with six years remaining, it is quite possible that the fair market value of the note may be considerably less than its current face amount.

Assuming the note's fair market value on the date of gift is $95,000, the recognizable gain would be calculated as follows:

Fair market value of note on date of gift		$95,000.00
Basis of the obligation		
Face amount	$122,324.32	
Less income reportable if fully paid (Gross profit ratio of 30%)	$36,697.30	85,627.02
Taxable gain on disposition		$ 9,372.98

This immediate recognition of the long-term capital gain will also qualify for the capital gain deduction of sixty percent; consequently only $3,749.19 is includable in the donor's ordinary income for that year. (Examination should also be made as to the potential application of the Alternative Minimum Tax for Tax Preferences for any year in which a large capital gain is recognized.)[94]

---

[88] I.R.C. § 453B (1982).
[89] I.R.C. § 2512(a) (1982); Treas. Reg. § 25.2512-1 to-4.
[90] I.R.C. § 453B(a) (1982).
[91] I.R.C. § 453B(b) (1982).
[92] I.R.C. § 453B(a)(1) (1982).
[93] I.R.C. § 453B(a)(2) (1982).
[94] I.R.C. §§ 55, 57(a)(9)(A) (1982). *See supra* text accompanying note 20.

4. Children as Obligors

If parents, in conjunction with selling their home to their children, grant a purchase money mortgage and take back an installment obligation, serious income tax issues will arise if the child, as a beneficiary of the parents' estate, ultimately comes into ownership of the same note on which he is also the maker. If the parent affirmatively elected out of the installment reporting provisions, no problem will result since all gain on the sale has been recognized by the parent and the interest component of the obligation merely ceases upon its transfer to the child/beneficiary.

The taxpayers' attempt here may be to circumvent the installment obligation disposition rules[95] by cancelling the obligation and thus forever preventing the includability of the unreported and unrecognized gain. The Code thwarts this tack by requiring the recognition of gain in the event the obligation is cancelled or otherwise becomes unenforceable.[96] Of further consequence is the result of a transfer of the obligation to a "related person."[97] Because the Code provides that a child is such a "related person,"[98] the fair market value of the obligation must be treated as not less than its face amount,[99] which, in a situation where the rate of interest of the obligation is less than market value, will result in a greater amount of income tax inasmuch as no "discount" is allowed in computing the obligation's fair market value.

This tightening of the law can have adverse effects on the estate's income tax posture since the entire capital gain must be recognized in one fiscal period, while the necessary cash to fund this resulting tax liability may not be available until the maturity date of the note.

Extreme caution is necessary in advising the ultimate disposition of an installment obligation. Proper structuring will afford significant tax benefits.

5. Estate Tax Considerations

As a general rule, notes and other claims (together with accrued interest thereon) held by the decedent on the date of death are includable in the gross estate.[100] However, a lower value may be justified because of the stated interest rate or maturity date. The Service has recently ruled that the estate tax value of an installment note payable to a decedent may be less than its face value when the note provides for payment of interest at a rate below the prevailing interest rate on the date of the decedent's death.[101]

---

[95] I.R.C. § 453B (1982).
[96] I.R.C. § 453B(f) (1982).
[97] I.R.C. § 453B(f)(2) (1982).
[98] I.R.C. § 318(a)(1)(A)(ii) (1982).
[99] I.R.C. § 453B(f)(2) (1982).
[100] I.R.C. §§ 2033 and 2031(a) (1982); Treas. Reg. § 20.2031-4 T.D. 7077, 35 Fed. Reg. 18,461 (1970); Treas. Reg. § 20.2033-1(b), T.D. 6684, 28 Fed. Reg. 11,409 (1963).
[101] Letter Ruling 8229001, Feb. 1, 1982; Rev. Rul. 67-276, 1967-2 C.B. 321.

There is much dispute as to whether notes that are cancelled by their terms on the death of the obligee (decedent) are includable in the gross estate. It appears that the distinction lies in the method of cancellation and the terms of the notes themselves. If the notes are merely cancelled by the will, inclusion in the gross estate will be required on the theory that the decedent bequeathed the amount of the notes to the maker.[102] If, however, the terms of the note itself require cancellation upon the death of the obligee, inclusion in the gross estate may not be required on the theory that cancellation was a part of the agreed terms of the note and could not be unilaterally revoked by the decedent/obligee during his lifetime.[103] If the transaction is between a parent and child and is not bona fide—not at arm's length and not free from donative intent—a note is subject to inclusion in the gross estate although cancelled by the obligee's will.[104]

Caution would dictate that if the parent/obligee intends to cancel the indebtedness upon the obligee's death, the notes themselves should be self-cancelling; otherwise, a skirmish with the Service is probable.

6. Post-Death Considerations

If the decedent died owning the note receivable, it will generally be valued for estate tax purposes at its fair market value plus accrued interest as of the date of death.[105] However, if the property constitutes a right to receive an item of income which was owed to the decedent at his date of death, the Code specifically prohibits application of the step-up in basis provisions.[106]

If income were "grossed-up" it would make the amount ultimately recovered equal to its upwardly adjusted basis, thus resulting in no recognition of income. The Code effectively prevents this. In most cases the transfer of the note itself does not trigger recognition.[107] The pertinent section provides that the estate or person ultimately coming into possession of the property, in this case the note receivable, takes the property subject to the same income tax treatment to which the decedent was entitled prior to death.[108] Through this procedure, no income is allowed to escape taxation, but is reportable by the person to whom the benefit inures.

In the event the decedent's estate was subject to the payment of any federal

---

[102] Estate of Buckwalter, 46 T.C. 805 (1966) (holding includable); Overlander v. United States, 67 Ct. Cl. 531, 7 AFTR 9070 (1929); Treas. Reg. § 20.2033-1(b) T.D. 6684, 28 Fed. Reg. 11,409 (1963); Commissioner v. Austin, 73 F.2d 758 (7th Cir. 1934).

[103] Estate of John A. Moss (Bank of Clearwater), 74 T.C. 1239 (1980).

[104] Rev. Rul. 81-286, 1981-2 C.B. 177; Treas. Reg. § 20.2033-1(b) T.D. 6684, 28 Fed. Reg. 11,409 (1963).

[105] *See supra* note 100.

[106] I.R.C. § 1014(c); Treas. Reg. § 1.1014-1(c)(1), T.D. 7283, 38 Fed. Reg. 20,825 (1973); Treas. Reg. § 1.691(a)-3, T.D. 7728, 45 Fed. Reg. 72,650 (1980).

[107] Treas. Reg. §§ 1.691(a)-4(b), -5(b), T.D. 6808, 30 Fed. Reg. 3,435 (1965).

[108] Treas. Reg. § 1.691(a)-3, T.D. 7728, 45 Fed. Reg. 72,650 (1980).

estate tax and any Income in Respect of a Decedent (IRD) property was included therein, the Code allows an income tax deduction to the estate or the ultimate recipient of the note for a ratable portion of the estate tax paid,[109] attributable from inclusion of the *net value* of the IRD property. (The net value of IRD is the total estate tax value of all IRD items less the total estate tax deductions allowable for all deductions in respect of a decedent.[110] If the IRD property is capital gain in character, coordination with the capital gain deduction is required in order to prevent an overly favorable deduction.)[111]

From a planning perspective, the practitioner may be in a position to advise the owner of the note of the tax advantages of bequeathing the note receivable to the beneficiary who would likely be in the lowest tax bracket. Hence, the family tax burden would accordingly be reduced. It is possible for an installment obligation not to have any Income in Respect of a Decedent (IRD) for at least two reasons. First, the owner of the obligation may have affirmatively "elected out" of the installment reporting provisions[112] and thus fully recognized all gain in the year of sale; secondly, the obligation may not have generated any recognizable gain, e.g., when funds are to be repaid in installments. Thus the practitioner should first become familiar with the financial and tax details underlying the creation of the installment obligation before planning is undertaken for its ultimate disposition.

III. PRIVATE ANNUITY

A. *Overview*

A private annuity is an arrangement whereby an individual (the transferor) transfers property to another individual (the transferee, who is not in the business of selling annuities), in exchange for the transferee's promise to make periodic payments in fixed amounts to the transferor for the remainder of the transferor's and/or another's life.

1. Advantages

Because the transfered property is unequivocally deeded and possession is surrendered to the transferee,[113] the value of the property is removed from the transferor's gross estate. Reducing the taxable estate below the exemption equivalent ($325,000 for 1984) would produce no estate tax savings unless the transferor left

---

[109] For the method to calculate the estate tax paid resulting from the inclusion in the gross estate of the net value of IRD property, see I.R.C. § 691(c)(2) (1982).

[110] I.R.C. § 691(b) (1982).

[111] Section 691(c)(4) was enacted by P.L. 95-600, § 702(b), to be effective for estates of decedents dying after November 6, 1978, to clarify that for purposes of computing the estate tax deduction provided by § 691(c) involving capital gain property, the estate tax deduction shall be subtracted from the gain prior to the deduction for capital gains provided under § 1202(a).

[112] I.R.C. § 453(d) (1982).

[113] If otherwise, the property is subject to inclusion in the gross estate in accordance with the retained life estate provisions of I.R.C. § 2036 (1982).

an otherwise taxable estate which exceeded the exemption equivalent. Considering further the unlimited marital deduction,[114] the benefits of estate tax saving would indeed be quite remote for the average person desiring to transfer a residence which no doubt would be the bulk of the estate. Of greater benefit to the aging parent is the "assurance" of receiving a monthly annuity in the form of cash on which to live and perhaps knowledge that home ownership would be vested in the children.

2. Disadvantages

As will be discussed later, the transferee's basis is determined at two stages: first, when the agreement is executed, the basis is the value of the annuity promised. It is potentially further increased if the sum of the payments made during the transferee's life exceeds the value of the annuity at the time of the agreement. Secondly, the basis is redetermined at the time of the transferor's death.[115] If the possibility of the transferor's untimely and premature death is present, the transferee's basis will presumably be quite low. An inquiry of the transferee's intention for the property's ultimate use would seem advisable before further planning.

The opposite of the above situation may also be a disadvantage to the transferee. If the transferor should live beyond his actuarial life expectancy, the transfered property may very well cost the transferee more than if he had waited to acquire the property at the transferor's death (assuming of course that he would have taken it otherwise).

The transferor/parent should not retain any type of security interest in the property if his intent is to exclude the property from his gross estate. The argument has been successfully made that such an intention is tantamount to a retained life estate,[116] which must then be included in the gross estate of the transferor.[117]

If the transferor with an otherwise realizable gain attains his full life expectancy, he will utlimately recognize the full amount of such gain under a method similar to an installment sale (i.e., the difference between the property's adjusted basis and its fair market value on the date of the transfer).[118]

The transferee of course should be financially able to afford the established monthly annuity payment amount. Generally a personal residence does not generate cash although, depending on the term of the annuity contract, it may make available cash which would otherwise be used to provide the transferee with a residence. The adequacy of the transferee's cash-flow and his overall financial condition should be examined.

---

[114] I.R.C. § 2056(a) (1982).
[115] Rev. Rul. 55-119, 1955-1 C.B. 352.
[116] I.R.C. § 2037 (1982).
[117] Updike v. Commissioner, 88 F.2d 887 (8th Cir. 1937), *cert. denied*, 301 U.S. 708 (1937); Estate of Koert Bariman, 10 T.C. 1073 (1948); Sarah Bergan, 1 T.C. 543 (1943).
[118] Rev. Rul. 69-74, 1969-1 C.B. 43.

B. *Summary*

From the tax standpoint, an evaluation as to whether the private annuity arrangement should be considered as a means of transfering a family residence from one generation to another in order to generate cash for the parent should involve a comparison of the potential income taxes payable by the transferor during his lifetime and the estate tax which would result if the residence is retained. In most instances, income taxes would be greater than the reduction in estate tax. By proceeding with the private annuity, the step-up in basis provisions may potentially be forfeited.

Finally, nontax factors such as alternative living arrangements for the transferors, the likelihood of the transferee defaulting on the payments (with no security interest in the transferor), the transferor's need of additional income and the potential for family disputes may indeed militate against the use of a private annuity as the vehicle to provide the parents with cash for living expenses in their advancing years.

IV. Retained Life Estate with Gift of Remainder Interest to a Charitable Organization

A. *Overview*

Implicit in this alternative is the assumption that the owner does not have any children to whom he wishes to transfer the residence. Even though the owner might have children, his financial position might still allow for the transfer of a remainder interest. Either way, during the donor's lifetime the charitable organization will be made aware of the donor's generosity.

For the person with limited assets—other than the home—on which to survive, this planning device could accomplish the following:

1. Provide the owner with a residence for the remainder of his or another's life or lives.
2. Provide income on which to live.
3. Demonstrate generosity toward a favorite charity during lifetime.
4. Reduce death taxes and the cost of estate administration.
5. Generate an immediate income tax deduction resulting from a charitable gift.

This alternative creates a split-interest in the real estate: a present interest reserved by the grantor and a vested remainder in the charitable organization.

The conveying document would obviously require language reserving to the grantor (and spouse, if any) a life estate coupled with full use, possession and enjoyment. Further, the donor's residence need not be his *principal* residence; any *personal* residence used by the taxpayer will qualify.[119]

---

[119] Treas. Reg. § 1.170A-7(b)(3), T.D. 7207, 37 Fed. Reg. 22,982 (1972).

B. *Income Tax Deduction*

The donor will be allowed an income tax deduction[120] (subject to certain limitations)[121] in an amount equal to the present value of the remainder interest of the property's fair market value[122] (as of the date of gift) less a six percent discount factor to reflect straight-line depreciation.[123] Initially, one must determine the property's fair market value, which must then be allocated between depreciable improvements and nondepreciable land; further, the salvage value of the depreciable portion must be determined as well as its period of useful life.[124]

For example, assume (1) that the property, at date of gift, has a fair market value of $175,000 which is allocated between land worth $25,000 and improvements worth $150,000; (2) that the property's estimated useful life[125] is forty-five years, at the end of which time the salvage value of the depreciable portion ($150,000) will be $10,000; and (3) that the male donor is sixty years old on the date of transfer.

The maximum potential deduction would be calculated as follows:

Portion of property to be depreciated:		
Value of building on date of transfer	$150,000	
Less estimated salvage value	10,000	
		$140,000
Portion of property not subject to depreciation:		
Value of land on date of transfer	$ 25,000	
Plus estimated salvage value of improvements	10,000	
		$ 35,000
Initial age of life tenant (donor)	60	
Plus estimated life of building	45	
Terminal age	105	
Remainder factors (R factors):[126]		
At age of 60	11745.9258	
At terminal period of 105	.02056792	

[120] I.R.C. § 170(f)(3)(B)(i) (1982).

[121] *Id.*

[122] *Id.*; Treas. Reg. § 25.2512-9(f), T.D. 7077, 35 Fed. Reg. 18,464 (1970). These tables are now unisex with the only variable being the donor's age on the date of gift.

[123] I.R.C. § 170(f)(4) (1982); Treas. Reg. § 1.170A-12, T.D. 7370, 40 Fed. Reg. 34,337 (1975).

[124] Treas. Reg. § 1.170A-12(a)(2).

[125] Treas. Reg. § 1.170A-12(d).

[126] Treas. Reg. § 1.170A-12(f), Table C(1), Col. 2. These Tables have not been made gender neutral although Table LN within Treas. Reg. § 25.2031-7(f), from which Table C is partially derived, has been modified gender neutral.

West Virginia Law Review, Vol. 86, Iss. 4 [1984], Art. 9

Depreciation factor (D factor):[127]			
At age 60	2239.835		
The adjustment factor calculation:			
1. R factor—age 60	11745.92580000		
Less R factor—terminal period of 105	.02056792		
Difference in R factors	11745.90523208		
2. Useful life of building	45		
Times D factor—age 60	2239.835		
Product of D factor and useful life	100792.58		
3. Difference in R factors, divided by	11745.90523208		
Product of D factor and useful life	100792.58		
Equals Adjustment factor of	.11654		
Value of the entire remainder interest:			
Current value of depreciation portion			$140,000
Times present value factor of a remainder interest at age 60[128]	.25509		
Less adjustment factor	.11654	x	.13855
			$19,397
Plus current value of the nondepreciable portion	$35,000		
Times present value factor of a remainder interest at age 60	.25509		8,928
Total maximum potential income tax deduction			$28,325

In the event the donor as a condition of the gift demands an annuity from the donee, the income tax deduction is computed by subtracting the value of the annuity from the value of the gifted property.[129]

C. *Gross Estate Inclusion and Deduction*

The property's full fair market value on the date of the donor's death is subject to inclusion in the gross estate because of the retained right of possession or enjoyment.[130] However because the property now passes outright to the charitable donee, an offsetting charitable deduction is allowed[131] to the extent that the prop-

[127] Treas. Reg. § 1.170A-12(f), Table C(1), Col. 3.

[128] Treas. Reg. § 20.2031-7(f), Table A, Col. (4). Effective for transfers of a remainder interest made after November 30, 1983, the tables reflect a ten percent discount rate as opposed to the previous rate of six percent. Treas. Reg. § 20.2031-7(a), T.D. 7077, 35 Fed. Reg. 18,461 (1970).

[129] Rev. Rul. 72-438, 1972-2 C.B. 30.

[130] I.R.C. § 2036(a)(1) (1982).

[131] I.R.C. § 2055(a) (1982); Treas. Reg. § 20.2055-1(a), T.D. 8318, 39 Fed. Reg. 25,452 (1974).

erty's value was included in the decedent's gross estate.[132] It is imperative, though, that no intervening interest exist between the date of the decedent's death and the time at which the property becomes vested in the charitable donee.[133]

Further, the charity must be given the entire remainder interest in the residence; the remainder cannot be split or shared with a noncharitable beneficiary.[134]

In the same manner, no West Virginia Inheritance Tax would be due since property passing to a recognized charitable organization is exempt from taxation.[135]

D. *Income Tax Inclusion*

The discussion relating to an income tax deduction[136] assumed that the donor merely irrevocably transferred the remainder interest in his residence to charity. Should he desire to reserve an annuity in exchange for the residence, a totally different result would obtain.[137] This type of arrangement is labeled a "gift annuity." The donor's income tax deduction is reduced by the value of the annuity to be received in exchange for the residence.[138]

For federal estate tax purposes, if the donor is the only beneficiary of the annuity, and it is extinguished upon death, the annuity would not be included in his gross estate. However, if the donor predeceased his spouse who was also a recipient of the annuity during her lifetime, then the present value of her future interest in the annuity would be subject to inclusion in his gross estate.[139] This inclusion, though, may be offset by the marital deduction if the annuity benefit passes to the surviving spouse.[140] If, as a condition to the gift, the donor is to receive the annuity in exchange for the residence, the donor will be taxed under the annuity rules.[141] The presentation of an example is beyond the scope of this Note; however, the Regulations provide an excellent detailed example applicable to the transfer of a residence.[142]

E. *Summary*

This alternative presents an attractive method of accomplishing the various goals of a donor who wishes to generate income while living, to retain his residence, to currently provide for the ultimate disposition of a valuable asset to a selected charity, and, in addition, to receive an income tax deduction which may offset the taxable income generated through the annuity.

---

[132] I.R.C. § 2055(d) (1982).
[133] Rev. Rul. 76-357, 1976-2 C.B. 285.
[134] Rev. Rul. 76-544, 1976-2 C.B. 288.
[135] W. VA. CODE § 11-11-5(f) (1983).
[136] *See supra* text accompanying note 120.
[137] I.R.C. § 1011(b) (1982); Treas. Reg. § 1.1011-2, T.D. 7741, 45 Fed. Reg. 81,745 (1980).
[138] Treas. Reg. § 1.1011-2(c), Ex. 8.
[139] I.R.C. § 2039 (1982).
[140] I.R.C. § 2056(a) (1982).
[141] I.R.C. § 72 (1982).
[142] *See supra* note 138.

V. LEASE ARRANGEMENT

The alternative of an owner entering into a lease presupposes desired retention of the house, ability to alter the structure to create additional living quarters or the intent to move into other quarters while leasing the entire area of the current residence.

Regardless of whether the entire residence, or only a portion of it, is converted from personal use to the production of income, the owner will be entering into a situation resulting in income tax consequences which should be reviewed in advance. The owner must establish the date the residence was placed in service for purposes of computing allowable depreciation and other related expenses.[143] The property's depreciable basis is determined by its initial cost; added to this figure is the aggregate cost of improvements which increased the property's value.[144] An allocation of basis must be made between the land and the residence itself since only the residence—and not the underlying real estate—is subject to an allowance for depreciation.[145] If only a portion of the residence is to be leased, a further allocation (on the basis of square footage) between the leased and nonleased areas must be made, again since only that portion of the residence actually used in the production of income is eligible for a depreciation deduction.[146]

The owner should be advised to maintain a record-keeping system to properly document and retain information regarding the expenditure of funds on the newly leased premises. Particular emphasis on the following expenses should be noted: real estate taxes, hazard insurance premiums, interest, maintenance and repairs.[147] These expenses, in addition to allowable depreciation, are deductions in proportion to the percentage of the residence used in the production of income. Thus, if fifty-five percent of the area of a residence is leased (and the remaining forty-five percent is retained by the owner), then fifty-five percent of the above expenses will be allowed as a deduction against the rental income generated from such property. Rental income received for each tax year will be includable in the owner's gross income.[148]

One caveat must be mentioned. If the taxpayer elects to convert all or a portion of the residence and further intends to use the rollover of gain provisions,[149] the only nonrecognizable portion of the ultimate gain is that part allocable to the

---

[143] Treas. Reg. § 1.167(a)-10(b), T.D. 7828, 47 Fed. Reg. 38,514 (1982).

[144] I.R.C. §§ 167(g), 1011(a), 1016(a)(1); Treas. Reg. § 1.167(g)-1, T.D. 6712, 29 Fed. Reg. 3,653 (1964).

[145] Treas. Reg. § 1.167(a)-5, T.D. 6500, 25 Fed. Reg. 11,462 (1960).

[146] I.R.C. § 167(a)(2) (1982).

[147] I.R.C. § 212 (1982); Treas. Reg. § 1.212-1(b), (h), T.D. 7345, 40 Fed. Reg. 7,439 (1975).

[148] I.R.C. § 61(a)(5) (1982); Treas. Reg. § 1.61-8(a)-(b), T.D. 6500, 25 Fed. Reg. 11,402 (1960). Rental income and the related expenses (including depreciation), are reported using IRS Schedule E, Supplemental Income Schedule.

[149] I.R.C. § 1034 (1982). *See supra* text accompanying note 54.

portion of the residence used by the taxpayer;[150] the portion leased is not subject to gain deferral but will be subject to immediate recognition of gain, if any.

The fact that the premises are rented for a period of time is not necessarily determinative that the property is not used by the taxpayer as his principal residence; a "temporary" period of renting may be allowed determined in light of all the facts and circumstances of each case.[151] When the taxpayer/owner decides to rent his residence, or a portion thereof, for the primary purpose of generating income or cash on which to live, it would appear, in most cases, that a decision has been made not to reconvert the premises to residential use. The cases generally hold that such an intent shall be construed against the taxpayer and thus it would preclude use of the deferral provision should he wish to replace that residence.[152] All is not lost, though, since the one time exclusion of gain[153] may be used if the taxpayer otherwise qualifies.

Before proceeding under the lease alternative, the practitioner would be prudent to make diligent inquiry of the owner's intent and motive regarding the time frame in which he wishes to rent the premises. This is necessary to prevent the unintended disqualification of significant tax benefits which may be lost through oversight.

VI. Debt Financing

A. *Overview*

Debt financing may be a viable alternative when one's life expectancy is low, need for income is low or where moderate supplementation is required and retention of ownership of the residence is desired.

A financing innovation which apparently has not yet come into nationwide vogue is a vehicle known by names such as the Inverse Amortization Loan or Reverse Annuity Mortgage. These financing arrangements provide the owner with a fixed or variable sum of money on a predetermined payment plan (annuity) in return for pledging his property (residence) as security for the annuity payments made by the lender. As the number of payment periods increase, the amount of the loan also increases. Thus, over time, the owner becomes indebted to the lender for greater sums of money.

This alternative presupposes that the owner's needs for funds will not proceed beyond his anticipated life expectancy and that the property is free of major encumberances. Assuming this, the full effects of this transaction from a tax stand-

---

[150] Treas. Reg. § 1.1034-1(c)(3)(ii), T.D. 7625, 44 Fed. Reg. 31,013 (1979).

[151] Treas. Reg. § 1.1034-1(c)(3)(i), T.D. 7625, 44 Fed. Reg. 31,013 (1979).

[152] Trisko v. Commissioner, 29 T.C. 515 (1957), *acq.*, 1959-1 C.B. 5; Barry v. Commissioner, 30 T.C.M. 757 (1971); Andrews v. Commissioner, 41 T.C.M. 1538 (1981); Private Letter Ruling 8132017, (April 30, 1981).

[153] I.R.C. § 121 (1982).

point are not entirely clear. However, suggestion of the following would seem well reasoned.

1. There would be no sale or exchange because the legal title to the property has been retained while the equitable title has been conveyed to secure the loan.

2. Upon death, the full fair market value of the property would be included in the decedent/owner's gross estate.[154] The principal amount of the debt, plus accrued interest thereon, would be allowed as a deduction from the gross estate.[155]

3. For West Virginia Inheritance Tax purposes, the same inclusion and deduction would apply.[156]

A most interesting issue is whether any of the increasing amount of the obligation incurred by the owner ever becomes deductible as interest paid on that obligation. The Code expressly provides that interest shall be allowed as a deduction within the taxable year in which it is paid or accrued.[157] The Service has held that a cash basis borrower does not have an interest deduction until such time as interest payments are made in either cash or property.[158] In addition, the fact that a note is given in payment of the unpaid interest or that the amount of unpaid interest is merely added to the principal balance has been held by the Service not to constitute a payment which would result in a bona fide tax deduction.[159]

The disallowance of a current deduction for interest, in some cases, may not be detrimental for taxpayers whose income may not be of a sufficient amount to result in taxation. Thus, the initial interest deduction would not be wasted.

Nevertheless, at least upon death, the full amount due to the lender would be deductible for federal estate and West Virginia inheritance tax purposes. The ultimate deduction is not lost, but merely deferred.

Of course, if the debtor were able to pay the computed interest from funds not traceable to the lender, then such payment would seem to be deductible in the year in which payment was made.

B. *Summary*

This alternative should be undertaken only after diligent review of the mortgage and loan documents, the current financial posture of the debtor and his anticipated life expectancy. A preliminary determination of the owner's income tax situation should be made to determine if interest payments (if needed) could be made from an alternate source of funds (e.g., retirement benefits, social security or others).

---

[154] I.R.C. § 2033 (1982).
[155] I.R.C. § 2053(a)(4) (1982).
[156] W. VA. CODE § 11-11-5 (1983).
[157] I.R.C. § 163(a) (1982).
[158] Rev. Rul. 80-248, 1980-2 C.B. 164.
[159] Rev. Rul. 73-482, 1973-2 C.B. 44; Rev. Rul. 70-647, 1970-2 C.B. 38.

Significant problems will arise if the owner outlives the expected annuity period: no equity will remain in the residence, there would be no continued source of funds and the lender will no doubt look to satisfy the debt through foreclosure of the trust agreement.

CONCLUSION

The practitioner will no doubt conclude that the area of retirement planning, especially with regard to one's residence, presents many competing interests and concerns, including the client's psychological attachment to his residence, his feelings and attitudes toward his children, his overall tax position, his views toward life and death and the degree to which financial assistance is needed.

Only by eliciting these thoughts and information from the client will the practitioner be in the proper position to mold a financial plan unique to the client's needs which will concomitantly result in the maximum productive use of his personal residence.

D. Frank Hill, III